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IMT
GROUP

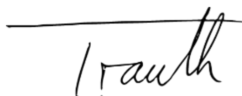
INVESTMENT OUTLOOK 04.2020

18 April 2020

The Covid-19 pandemic came as a surprise to all of us. The lockdown and social distancing measures put an abrupt stop to economic activity, which will lead to unprecedented falls in GDP figures. As a result, we have observed the fastest equity sell-off in history. Global equity markets dropped by more than 30% in only 22 days. The outlook for the economy and financial markets remains highly uncertain, although equity markets have rallied in recent weeks.

The policy response is unparalleled, with fiscal and monetary support programs by far exceeding any past policy measures.

We remain cautiously positioned due to the extremely high levels of uncertainty and the risk of renewed market disruptions. Nevertheless, we may use future market weakness to re-risk our portfolios.



Thomas Trauth
CEO – IMT Asset Management AG

COVID-19 PANDEMIC

Financial markets

We have observed the fastest sell-off in history. Equity markets fell by more than 30% within 22 days. From the peak reached by the markets on 19 February to the trough on 23 March the S&P500 index, for example, lost 34%. Since then the markets have rebounded strongly and gained 27%. This brings year-to-date performance to -12%.

As expected, the more defensive Swiss SMI index outperformed during the sell-off, while the European equity index, with a high weight of cyclical stocks and financials, experienced the biggest loss. Energy stocks and financials underperformed. On average, emerging markets performed in line with developed markets. China was a clear outperformer, however, while the Indian Nifty 50 and the Brazilian Ibovespa, for example, were hit hardest due to concerns about their countries' handling of the Covid-19 crisis.

Interest rates fell sharply, because of concerns about the depth of the recession and decisive central bank actions. However, it seems that European yields had little scope to drop further, below the -1% level. This may suggest that going forward government bonds may not provide the desired protection if the crisis should further accelerate. Credit spreads widened significantly, and the credit markets dried out. Trading activities almost stopped completely in certain segments of those markets. In April, however, credit markets rebounded somewhat.

The gold price fluctuated greatly. When the crisis hit, gold initially sold-off and fell from around USD 1,680 to as low as USD 1,470 on 19 March when equity markets hit their lows. Therefore, gold failed to display its hedging properties. Gold then recovered and is currently trading at around USD 1,690.

In addition to the Covid-19 crisis the market was shocked when, on 6 March, talks between OPEC and Russia failed to agree on new oil output cuts. As a result, the oil market collapsed as rising supply met a sharp drop in demand. The price for Brent oil, for example, dropped by more than 60% in March.

Also, REITS were hit hard as concerns about the ability of tenants to pay their rent mounted.

Volatility in the currency markets rose strongly. The EUR/USD exchange rate underwent unusually strong fluctuations. The EUR weakened against the USD, the CHF and the JPY and appreciated against most other currencies, especially against commodity and emerging markets currencies.

Macroeconomics

The lockdown and social distancing measures introduced in almost all developed countries are tantamount to an emergency braking. In many sectors, especially travel and hospitality, activity virtually stopped altogether. March PMIs fell but may not yet reflect the full impact. You do not have to be a prophet to expect catastrophic growth indicators for the coming months.

Non-farm payrolls in the USA declined by 701,000. US initial jobless claims shot up to a staggering 6.6 m for the week of 3 April, after 6.8 m and 3.3 m in the weeks before. Meanwhile, the Chinese PMI recovered to 50.1 following a sharp drop to 40.3 in February, reflecting the fact that China was the first country to relax its lockdown measures.

The March inflation figures dropped sharply. US headline inflation fell to 1.5% after 2.3%, and EMU inflation dropped to 0.7% after 1.1%. This reflects the deflationary nature of the current crises, reinforced by falling energy prices. As a result, 10-year break-even inflation rates, i.e., market-implied long-term inflation expectations, fell significantly below 1% in the US and came close to zero in Europe.

Monetary and fiscal policy response

The fiscal response in the major developed countries was swift and decisive. The US, the EU, the UK, and Japan announced fiscal packages which in total amount to USD 3.2 tn in 2020. This equals about 10% of GDP. The US fiscal deficit could be as high as 15% this year.

Fiscal measures were accompanied by aggressive monetary easing. All major central banks cut rates. The US Fed, the ECB, the Bank of England, and the Bank of Japan announced the purchase of assets totaling a staggering USD 6.8 tn. The US Fed alone bought USD 4 to 5 tn of assets. The ECB announced its Pandemic Emergency Purchase Program (PEPP) worth EUR 750 bn. Effectively, central banks are prepared to backstop upcoming sovereign bond issuance.

Fiscal as well as monetary measures by far exceed the measures taken in 2008 and 2009 during the global financial crisis.

Outlook

A global recession has become reality overnight. Now the major question is, will the economy be able to recover swiftly or will we plunge into a global depression? A depression is defined as a sustained long-term downturn of economic activity, in contrast to a recession, which has an average duration of 11 months.

The answer to this question largely depends on the length of the lockdown and whether the policy measures will prevent a large wave of insolvencies. If the majority of companies can be kept afloat, economic activity is more likely to pick up swiftly. If, however, a large number of companies were to go under, unemployment would rise permanently and we would see severe damage in bank balance sheets and possibly in real estate markets. In such a case, economic damage would be huge and it would take many years to repair balance sheets and to rebuild economic structures.

The duration of the lockdown measures depends on how well we can contain the spread of the corona virus. Currently the number of CORVID-19 cases stands at 2.2 m worldwide, which is an extremely small percentage of the world population. In our view, there are only two possible sustainable solutions.

The first solution is to find a vaccine. While a lot of effort is currently being put into research and initial human trials are taking place, it will take many more months of intense work to develop a vaccine. It will then take many months again to create the global production capabilities needed.

The second solution is to create herd immunity. Once 50-60% of the population has had the virus and thus become immune, the threat will diminish. However, since we need to control and slow the spread of the virus in order to prevent the health system from collapse, and given the exceptionally low number of corona cases, it will take years to achieve herd immunity.

As a result, we think that for the foreseeable future we will be faced with the threat that the spread of the virus may again accelerate. Especially after lockdown measures are relaxed, we may be faced with second waves.

As a result, we continue to see major uncertainties about the future course of the economy and financial markets. The recent equity market rally suggests that market participants expect a smooth economic recovery.

We believe that we will be able to avoid a global depression and that policy measures will prevent the

worst. We foresee a recovery of the global economy in the fourth quarter of 2020 and in 2021. But this scenario is fraught with considerable unforeseeable risks. One such might be a second wave of infections after the initial restrictions have been lifted. Therefore, we also believe that we will be faced with further setbacks and disappointed expectations.

For these reasons we believe that it would be premature to raise the equity allocation. We are observing the situation carefully and as it becomes more stable, we will gradually increase the levels of portfolio risks or realize gains on our equity hedge.

ECONOMICS

The lockdown and social distancing measures introduced in almost all developed countries are tantamount to an emergency braking. In many sectors, especially travel and hospitality, activity has virtually stopped altogether. March PMIs fell but may not yet reflect the full impact. US non-farm payrolls declined by 701,000. US initial jobless claims shot up to a staggering 6.6 m for the week of 3 April. Meanwhile, the Chinese PMI recovered to 50.1 following a sharp drop to 40.3 in February.

Fig. 1: PMIs

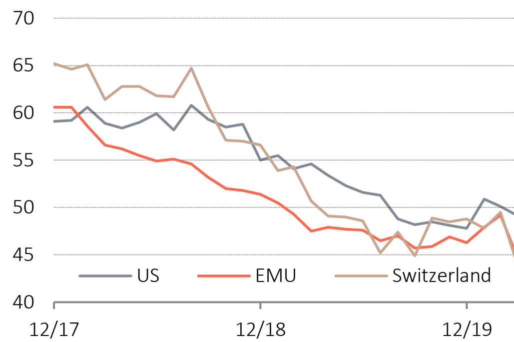


Fig. 2: PMIs

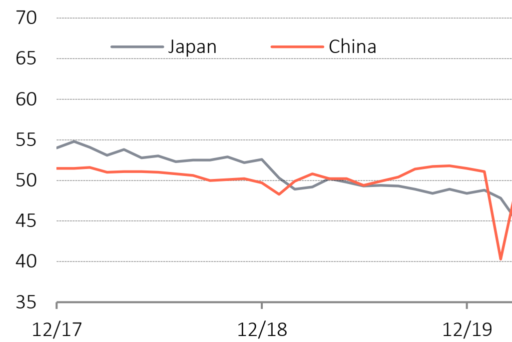


Fig 3: Consumer price inflation, in % YoY

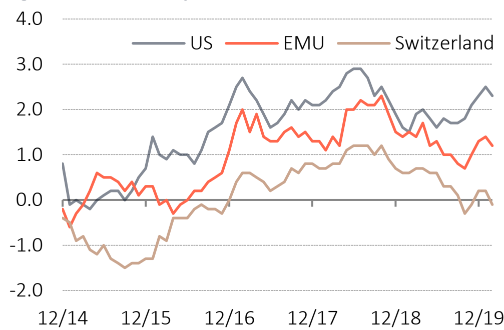


Fig. 4: Consumer price inflation, in % YoY

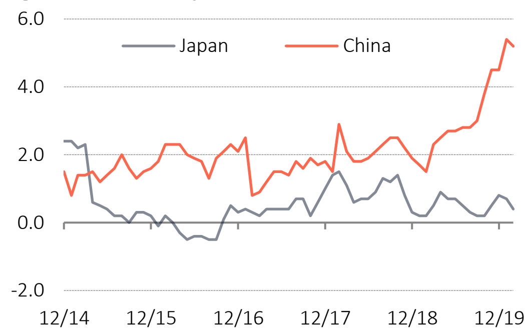


Fig 5: Unemployment rates, in %

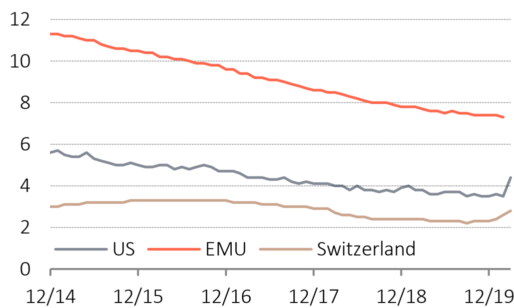
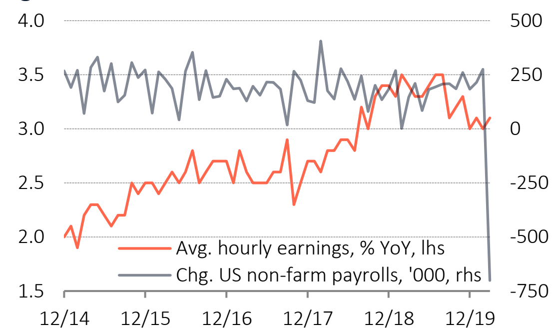


Fig 6: US labor market



FIXED INCOME

Interest rates fell sharply, due to concerns about the depth of the recession and decisive central bank actions. However, it seems that European yields had little scope to drop further, below the -1% level. This may suggest that government bonds may not provide the desired protection if the crisis should further accelerate. Credit spreads widened markedly, and the credit markets dried out. Trading activities almost stopped completely. In recent days, credit markets have rebounded.

Fig.7: 2Y government bond yields

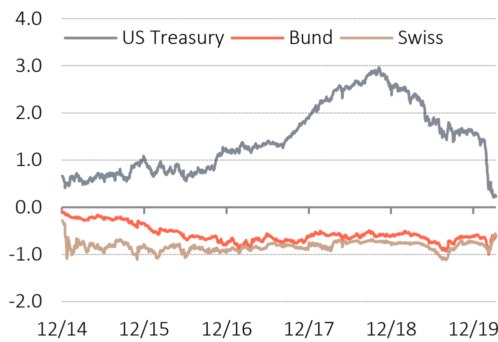


Fig. 8: 10Y government bond yields

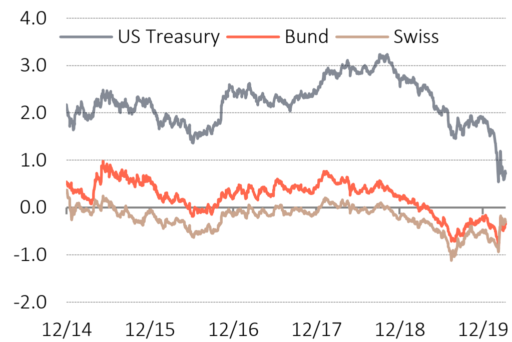


Fig 9: 10Y break-even inflation

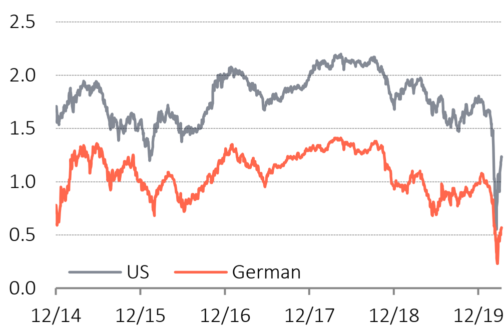


Fig. 10: Credit spreads, 5Y credit default swaps

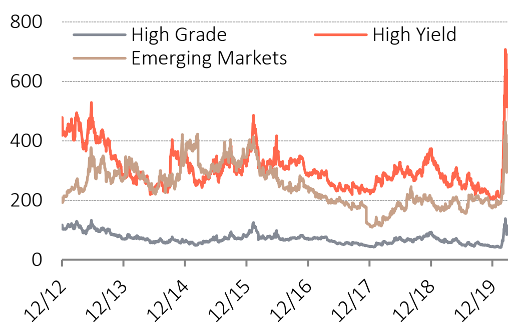


Fig 11: Money market spreads (3M-2Y)

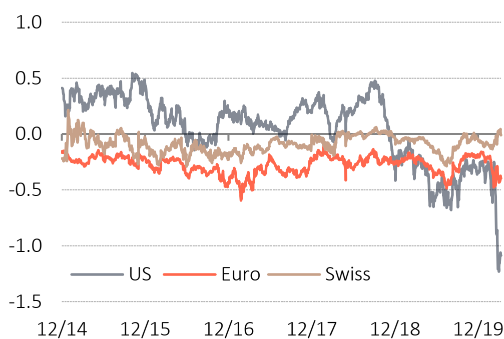
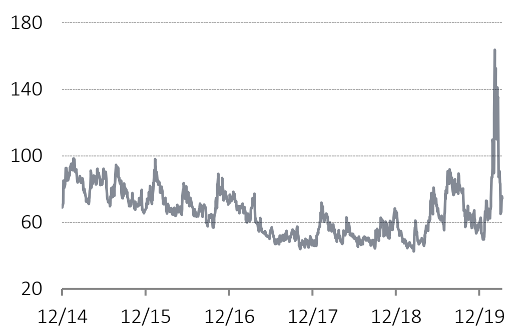


Fig 12: Merrill Lynch volatility index (MOVE)



EQUITIES

We observed the fastest sell-off in history. Equity markets fell by more than 30% within 22 days. As expected, the more defensive Swiss SMI index outperformed during the sell-off, while the European equity index, with a high weight of cyclical stocks, for example financials, experienced the biggest losses. Energy stocks and financials underperformed. Emerging markets performed in line with developed markets on average. However, China was a clear outperformer, while, the Indian Nifty 50 and the Brazilian Ibovespa, for example, were hit hardest due to concerns about their countries' handling of the Covid-19 crisis.

Fig. 13: MSCI equity indices – major regions

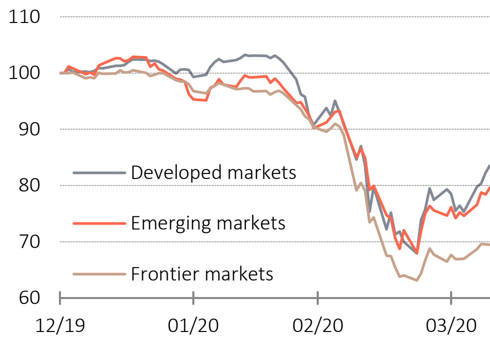


Fig.14: Equity indices – major developed markets

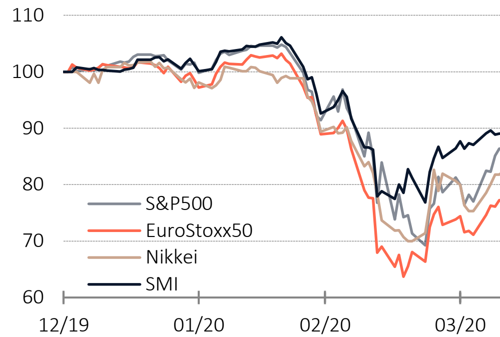


Fig 15: Equity indices – major emerging markets

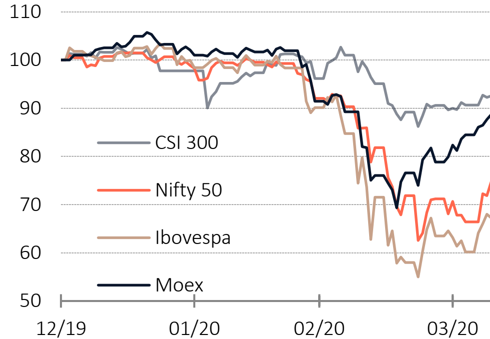


Fig. 16: Sector performance, MSCI Europe, 2018

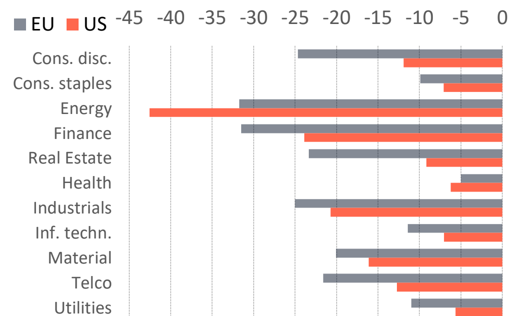


Fig 17: Price-earnings ratios

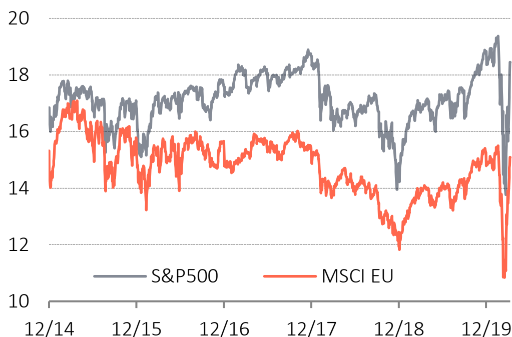
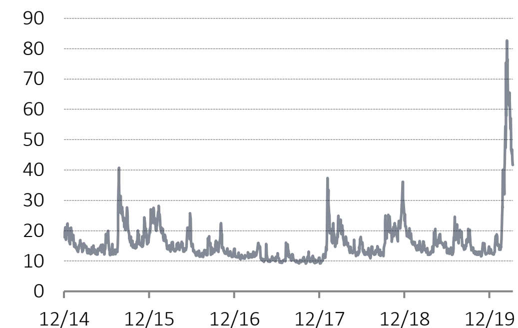


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

The gold price fluctuated greatly. When the crisis hit, gold initially sold-off and fell from around USD 1,680 to as low as USD 1,470 on 19 March, when equity markets hit their lows. Gold then recovered and is currently trading at around USD 1,690. After the OPEC+ talks failed, rising oil supply coincided with a sharp drop in demand. The price for Brent oil, for example, dropped by more than 60% in March. Also REITS were hit hard as concerns about the ability of tenants to pay their rent mounted.

Fig. 19: Gold price, USD/oz

Fig.20: Brent oil price, USD/bl

Fig 21: Bloomberg commodity indices

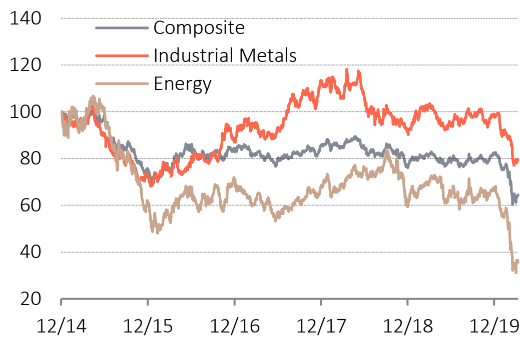


Fig. 22: HFRU hedge fund indices

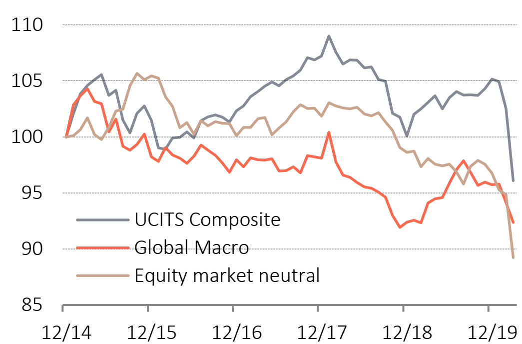


Fig 23: FTSE EPRA/NAREIT global REITS index

Fig 24: LPX global listed private equity

CURRENCIES

Volatility in the currency markets rose strongly. The EUR/USD exchange rate underwent unusually strong fluctuations. While the EUR weakened against the USD, the CHF and the JPY, it appreciated against most other currencies, especially against commodity and emerging markets currencies.

Fig. 25: EUR-USD exchange rate

Fig. 26: GBP-USD exchange rate

Fig 27: USD-JPY exchange rate

Fig. 28: USD-CNY exchange rate

Fig 29: EUR-CHF exchange rate

Fig 30: USD-CHF exchange rate

ASSET ALLOCATION

Despite a strong start into 2020, risky assets sold off dramatically after 19 February. Year-to-date almost all asset classes show clear losses, except for government bonds and gold. Commodities, especially industrial metals and oil also fell. Safe-haven currencies, like CHF and JPY, gained, while commodity and emerging markets currencies experienced the biggest losses.

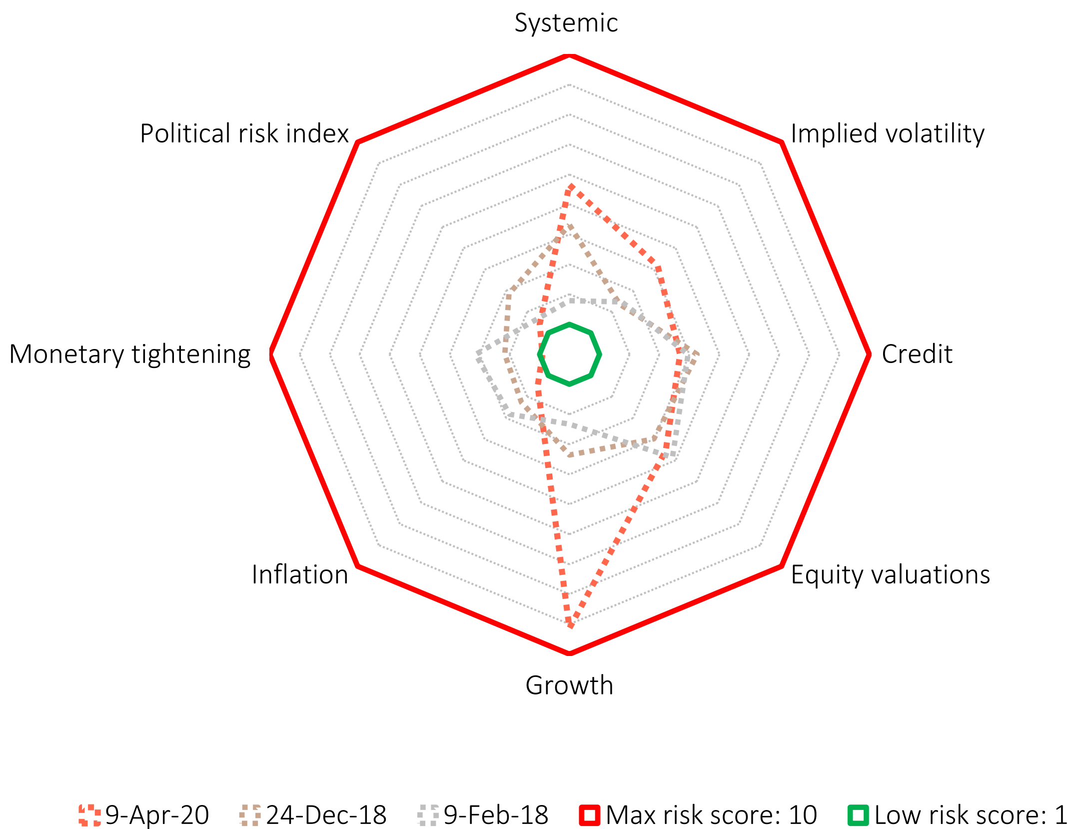
Fig. 31: Performance of major asset classes, based on our EUR portfolio strategy

RISK MONITOR

Growth risks have taken center stage. With global PMIs dropping drastically a recession has become reality. Since the peak of the crisis, around 20 March, systemic risks and implied volatilities declined, but clearly remain elevated. Equity valuations have declined significantly. Monetary tightening risks have basically vanished as central banks around the world inject large amounts of liquidity into the markets.

Fig. 32: IMT Risk Monitor

24 Dec 2018: Growth and monetary tightening fears
09 Feb 2018: Inflation fear and technical correction



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